

M&A: Facilitate Deal-Making through the Use of Representation and Warranty Insurance

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In this frothy, seller-driven M&A market, representation and warranty insurance can help bridge the gap between a buyer and seller and facilitate deal-making.

In M&A transactions, a seller seeks to limit the extent to which a buyer will have recourse to a seller after consummation of the acquisition. In today's middle market—\$20 to \$100 million deal size—it is not unusual for escrows or holdbacks to be as small as 5% to 10% of the cash purchase price, indemnities for breaches of representations and warranties to be limited to 10% to 15% of the cash purchase price, and time period for a buyer to make an indemnity claim to be as short as one year. A representation and warranty insurance policy can be purchased by a buyer to provide greater protection and enable that buyer to submit a more competitive bid for the business.

Representation and warranty coverage essentially provides coverage for breaches of a seller's representations and warranties that are discovered post-closing. The insurance coverage operates to shift transaction risks from the buyer and the seller to an insurer who assumes those risks for a fee. The insurance policy can extend a seller's indemnity obligations beyond the negotiated dollar cap and the duration of the survival period beyond the contractual survival period. Representation and warranty insurance will not cover matters that were disclosed to the buyer, or matters that were actually known by the deal team. The policy also will not cover instances of actual fraud. Other exposures that may be excluded include (a) environmental, (b) unfunded pension, (c) working capital adjustments, (d) forward-looking statements, (e) Medicare/Medicaid, and (f) claims for nonmonetary relief.

Like most insurance policies where an insured must have "skin in the game," representation and warranty insurance will be subject to a deductible, after which the buyer will have direct recourse to the insurer. The cost of representation and warranty insurance currently ranges from 3% to 5% of the insurance coverage amount, and the deductible currently ranges from 2% to 3% of the coverage amount, which can be satisfied by seller's escrow or indemnity obligation. In addition to receiving a portion of the premium the insurance broker often will receive an additional 50-75 basis points from the buyer.

The process involves the insurance broker obtaining an initial nonbinding indication of interest (NBII) from six to eight insurance companies, based on a term sheet, letter of intent or draft purchase agreement. From the handful of NBII's received, one NBII will be selected. There is then a due diligence call enabling the broker and the insurance company to obtain information about the scope of the due diligence performed by the buyer. Finally the broker and insurance company will seek access to the data room and conduct their own due diligence. It is often the case that representation and warranty insurance can be underwritten in less than one month.

Representation and warranty insurance may be particularly useful in the following situations:

- A seller will have a continuing business relationship with the business after the consummation of the acquisition
- A seller has limited financial resources or is financially distressed
- A seller, such as a private equity fund, seeks a clean exit
- When there are multiple sellers and there is several liability but not joint liability
- Cross-border transactions where it may be difficult to enforce a seller's indemnity
- To distinguish a buyer's bid in a competitive bidding process

When negotiating a representation and warranty insurance policy, care should be taken to minimize the gap between purchase agreement and policy provisions with respect to the scope of the representations and warranties, the definition and calculation of "loss," including materiality scrapes, the impact of recovery of insurance proceeds and tax benefits, and indemnification mechanics. If the buyer is using third-party financing, the buyer should consider naming the lender as an additional insured or loss-payee under the insurance policy. In providing information about a proposed deal, including due diligence reports, to an insurance broker and insurance company, consider having confidentiality agreements and nonreliance letters in place.

The use of representation and warranty insurance is becoming more common, and potential buyers should explore the use of representation and warranty insurance to maintain their competitive advantage.